Annual Report 1978

fil

Canadian National Railways

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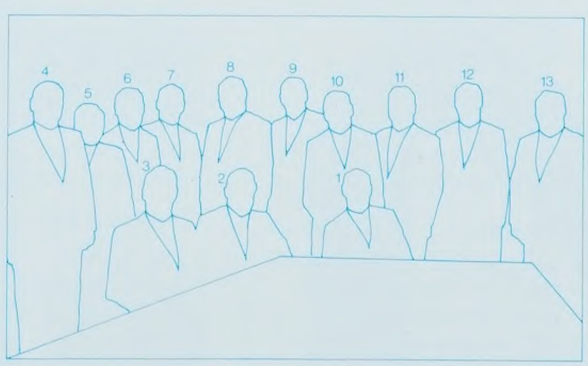
Annual Report 1978

Canadian National Railways



SYSTEM
Highlights

	1978	1977
Financial Results		
Gross revenues	$2,870.3	$2,612.1
Income before interest on debt	232.7	184.1
Total interest charges	95.2	154.8
Income taxes (net)	1.4	1.3
Net income	$ 136.1	$ 28.0
Dividend	$ 27.2	
Capital Expenditures		
Total expended	$ 375.2	$ 371.4
Capital value of leased rail and rolling stock acquired	$ —	$ 6.4
Capital Structure		
Long-term debt	$1,322.3	$1,568.3
Equity	$2,497.5	$2,388.6
Debt/Equity ratio	35/65	40/60
Return on investment	6.0%	4.8%
Employees		
Average number of employees	78,247	78,671
Average annual wage per employee	$ 18,054	$ 16,958

Note:
Dollars in all tables are expressed in millions except average annual wage per employee and consolidated financial statements.

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To the Honourable
The Minister of Transport
Ottawa

Dear Mr. Minister:

The Board of Directors is pleased to submit the Annual Report of Canadian National Railways for 1978.

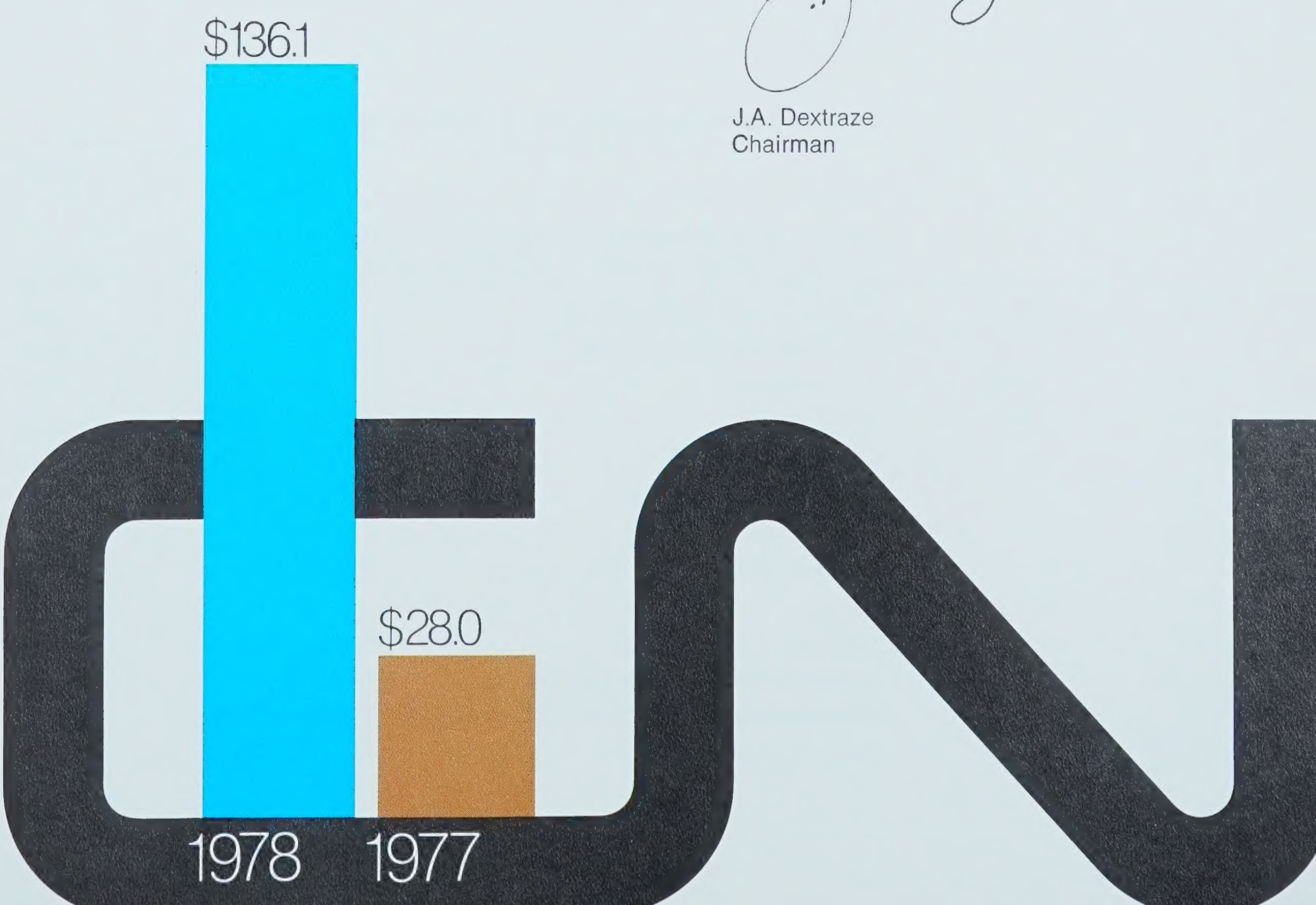
In a period characterized by slow economic growth and market uncertainties, the dedication and skill of management and staff have helped make 1978 the best year in this Corporation's history not only from a service and operational viewpoint but from a financial standpoint as well.

The changes in the capital structure of Canadian National which were approved by Parliament during the year are having a major positive effect on the Corporation and the Board acknowledges the role of Government in initiating and advancing the necessary legislation.

The Board believes that the progress made by Canadian National in 1978 has set a solid foundation for an increasing contribution to the economic growth of Canada in the years ahead.

Yours sincerely,

J.A. Dextraze
Chairman



President's Review

In 1978 Canadian National achieved the best financial results in its 56-year history. The Company earned a net income after taxes of $136.1 million and was able to provide for a dividend of $27.2 million to be paid to the Federal Government. The results were obtained despite the fact that the rate of growth of the Canadian economy was well below the average of the past 20 years.

The recapitalization of Canadian National, which became effective on December 31, 1977, contributed to profitability by reducing annual interest charges. Even without recapitalization, however, the Company would have shown a net income of $71 million, more than two and one-half times the profit shown in 1977.

Despite the encouraging results of 1978 the return on investment of the Corporation as a whole is, at 6.0% still below acceptable commercial standards. I am confident, however, that the upward trend we have established will continue.

Progress has been made in removing numerous constraints to commercial viability and further efforts will continue in this direction.

System capital expenditures in 1978 were $375.2 million, marginally less than the combined capital expenditures and capital value of leased rail and rolling stock acquired in 1977.

CN's capital programs during the year were financed from profits, internally generated funds and by borrowing through a U.S. $120 million debenture issue in the United States.

The average number of employees on the System totalled 78,247 in 1978 a slight decrease from the 1977 average. In the latter part of the year approximately 2,300 CN employees were transferred to VIA Rail Canada Inc. and at year-end total CN employee count was approximately 74,500. The average annual wage per employee rose 6.5% over 1977 to $18,054.

The following pages elaborate on the 1978 performance of each division with the financial results stated in terms of income before interest and income

System Statement of Income — Division Basis

	1978	1977
Income before interest on debt and income taxes		
CN Rail	$257.2	$206.7
Grand Trunk Corporation	32.6	28.6
CN Telecommunications	30.4	25.2
CN Trucking	3.2	2.3
CN Express	(34.3)	(33.8)
CN Passenger	(56.1)	(49.9)
CN Hotels	1.7	(2.3)
CN Marine	(0.1)	—
Miscellaneous	(1.9)	7.3
	232.7	184.1
Interest charges (net)	95.2	154.8
Income before income taxes	137.5	29.3
Income taxes (net)	1.4	1.3
Net income	$136.1	$ 28.0

taxes. The section highlighting the financial performance of each division includes an estimate of operating ratio. This ratio which measures the cost of earning one dollar of revenue, before inclusion of financial charges, is a useful indicator of divisional performance.

On behalf of management I take this opportunity to acknowledge the part played by CN employees at all levels in the success which Canadian National has achieved in 1978. A principal objective of the restructuring of the Corporation in recent years has been to enable employees to become more directly involved in the decision-making process. Today more than ever the abilities of CN's people can be seen to be producing concrete and gratifying results.

R.A. Bandeen
President and Chief Executive Officer

System Capital Expenditures — Division Basis

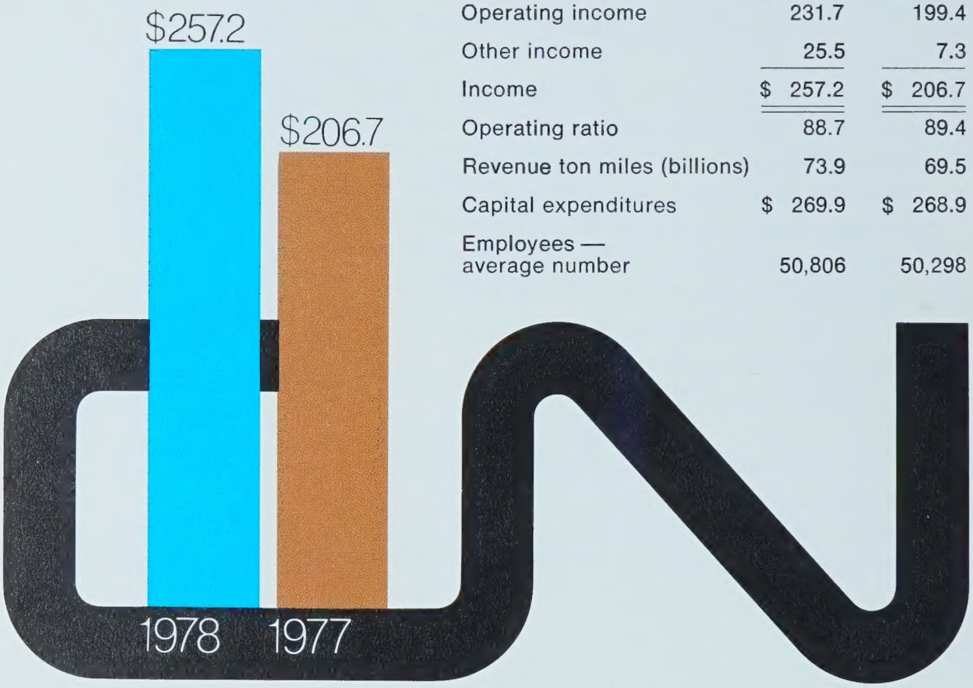
	1978	1977
CN Rail	$269.9	$268.9
Grand Trunk Corporation	39.8	25.3
CN Telecommunications	41.3	37.9
CN Trucking	6.9	6.7
CN Express	6.9	13.4
CN Passenger	—	—
CN Hotels	4.9	4.0
Miscellaneous	5.5	15.2
	375.2	371.4
Capital value of leased assets (Grand Trunk Corporation)	—	6.4
Total	$375.2	$377.8

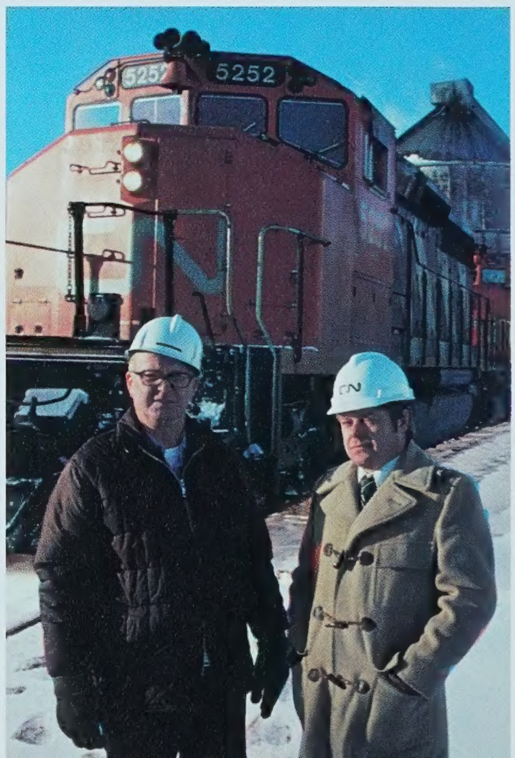
CN Rail

CN Rail revenues, which exceeded the $2 billion mark for the first time were 10.0% higher than in 1977 while expenses were 9.2% higher. The income of $257.2 million represented a 24.4% increase over 1977.

CN RAIL
Highlights

	1978	1977
Revenues	$2,059.4	$1,872.8
Expenses	1,827.7	1,673.4
Operating income	231.7	199.4
Other income	25.5	7.3
Income	$ 257.2	$ 206.7
Operating ratio	88.7	89.4
Revenue ton miles (billions)	73.9	69.5
Capital expenditures	$ 269.9	$ 268.9
Employees — average number	50,806	50,298

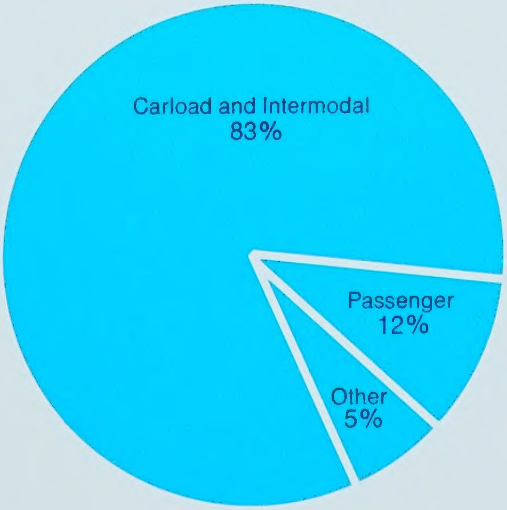




CN uses 100-car unit trains to move Alberta coal to Thunder Bay and Vancouver. It takes 12,000 horsepower to move this unit train through the Fraser Valley. The powerful engine (left) of such a train looms behind a CN marketing officer and a mine manager.

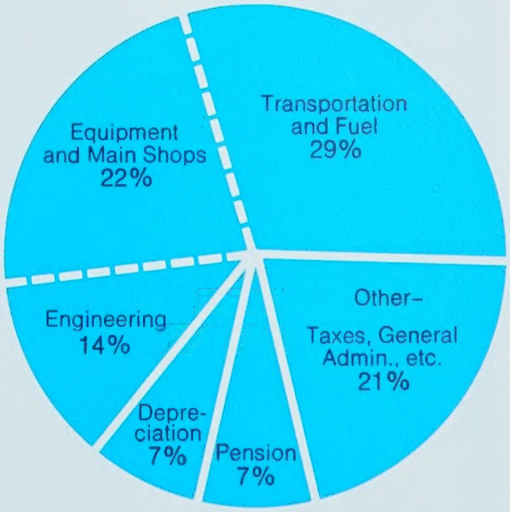
DISTRIBUTION OF REVENUES

$2,059.4 Million



DISTRIBUTION OF EXPENSES

$1,827.7 Million



Marketing

In spite of a generally sluggish economy, CN Rail was able to produce increases in revenue ton miles for most of its traffic segments.

Chart 1 illustrates the geographic distribution of CN Rail's freight activity. A major share of CN Rail's freight was carried on the Mountain and Prairie regions, encompassing British Columbia, Alberta, Saskatchewan, Manitoba, and parts of Northern Ontario.

Chart 2 segments this freight traffic into major commodity groupings.

The main contributors to business growth were forest products and fuels and chemicals. Demands for construction lumber were strong. Pulpwood and newsprint gains were mainly due to strikes in the newsprint industry in the northwestern U.S.

Potash and sulphur movements continued to improve and there was substantial new coal traffic from Alberta to Thunder Bay for Ontario Hydro.

The depressed value of the Canadian dollar in 1978 contributed to U.S. and other export demands, particularly in resource industries.

Operations

Productivity gains in all sectors reflected continued control of costs, benefits from capital investments and effective utilization of new technology. Average gross tons per train reached more than 4,000, a 3.6% increase over 1977, and car utilization continued to improve.

Attrition continued to provide train and yard crew expense reductions and it is anticipated that an agreement recently signed with the United Transportation Union, providing for the operation of freight trains with one less brakeman, will lead to additional productivity gains in coming years.

Large scale concrete tie programs and innovative new machines have led to increased productivity in track reconstruction.

Although extreme weather conditions in the United States throughout the early months of 1978 resulted in an unusually high number of cars being off-line, CN Rail was able to service increased Canadian traffic demands by decreasing on-line car cycles, and increasing the availability of cars through an intensive maintenance program.

During 1978, employee safety and accident prevention records improved again. Lost time injuries per million man-hours worked decreased to 15.91 from 17.88 in 1977. This 11% improvement is a result of a continuing program by CN Rail to make employees

CHART 1

REGIONAL FREIGHT
BILLIONS OF REVENUE TON MILES

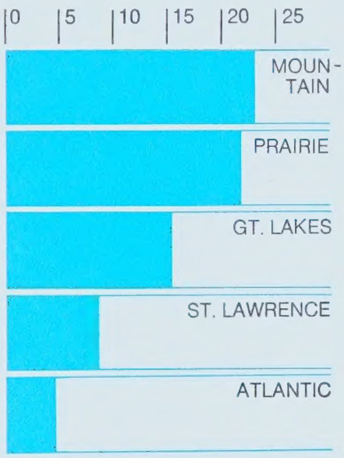
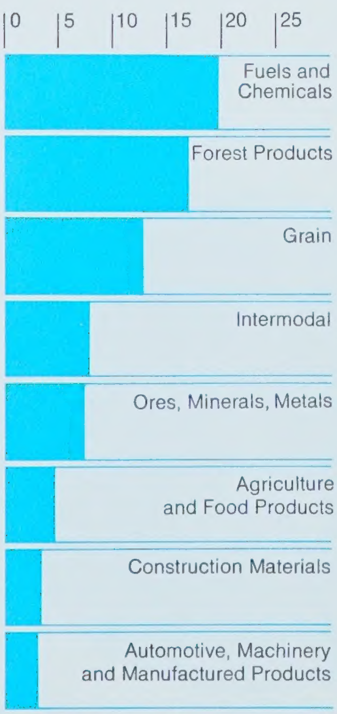
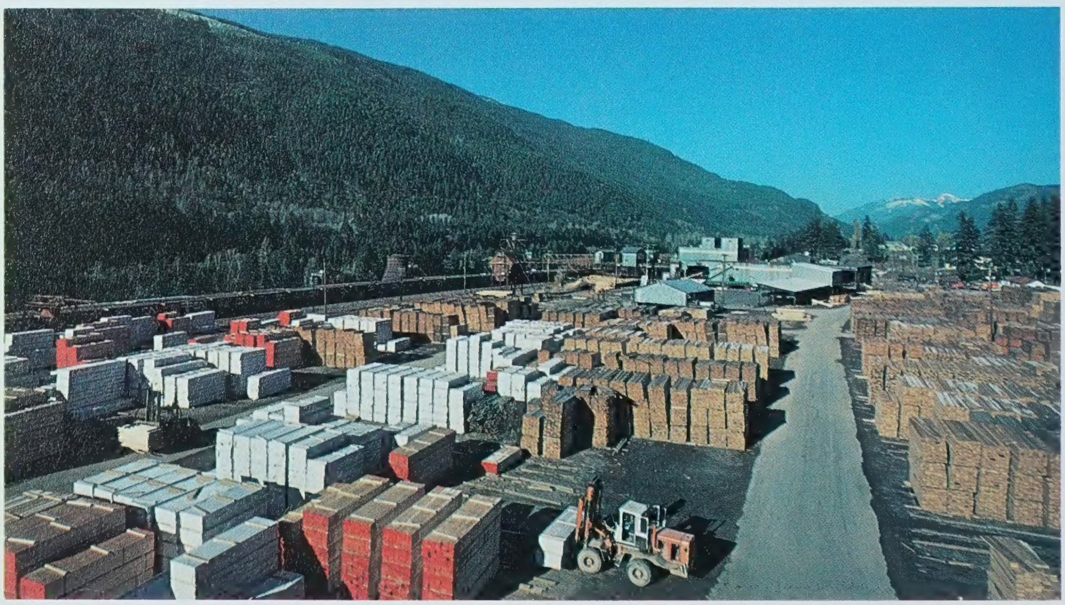


CHART 2

MARKET SEGMENT
BILLIONS OF REVENUE TON MILES





more safety conscious. In addition there was a 23% reduction in the total number of train and yard movement accidents in 1978.

During the year, large scale employee training programs continued. Major additions to the facilities at the Transportation Training Centre in Gimli, Manitoba, were completed in September and throughout the year new facilities for maintenance of way training went into operation at Joffre, Quebec; Transcona, Manitoba, and Kamloops, B.C.

Capital Expenditures

	1978	1977
Road property	$236.8	$248.0
Rolling stock	30.0	19.3
Intermodal equipment	3.1	1.6
	$269.9	$268.9

Capital spending on fixed plant reflected CN Rail's continued efforts to improve its traffic handling capability by selective investment in major rail line and yard expansion projects. Sufficient elements of CN Rail's on-going plant improvement program were completed during the year to permit the beginning of regular long train movements i.e. trains of 125 cars, between Toronto and Vancouver.

New investment in rolling stock was relatively modest despite the additional traffic volume handled in 1978. Most of the expenditure was for boosters for hump yard operations, modifications to rolling stock and the addition of special purpose freight cars.

The relatively low level of capital expenditures on rolling stock is a reflection of improved management control of the fleet from the full operations of TRACS (Traffic Reporting and Control System).

The prairie branch line rehabilitation program financed by the Federal Government continued in 1978. The objective of the program is to permit the continued utilization of certain branch lines in Western Canada. Capital and operating expenditures on road property and equipment amounted to $49 million in 1978. Capital expenditures, offset by the grant received from the Government, are not included in the table above.

Getting Canadian lumber to world and domestic markets is important to the Canadian economy.

CN marketing teams, such as the one below, are part of the national effort.

CN Passenger

Canadian National continued transferring responsibility for intercity passenger services to VIA Rail Canada Inc. during 1978. With the rationalization of Transcontinental services in October, VIA took over responsibility for passenger train services formerly provided by CN between Montreal/Toronto and Vancouver.

While the establishment of VIA did not have a significant financial impact on the Corporation in 1978, it is anticipated that with complete rationalization in 1979 Canadian National's losses in providing intercity passenger services will be reduced and eventually eliminated.

During 1978, CN losses in providing passenger services increased to $56.1 million, up 12.4% from 1977.

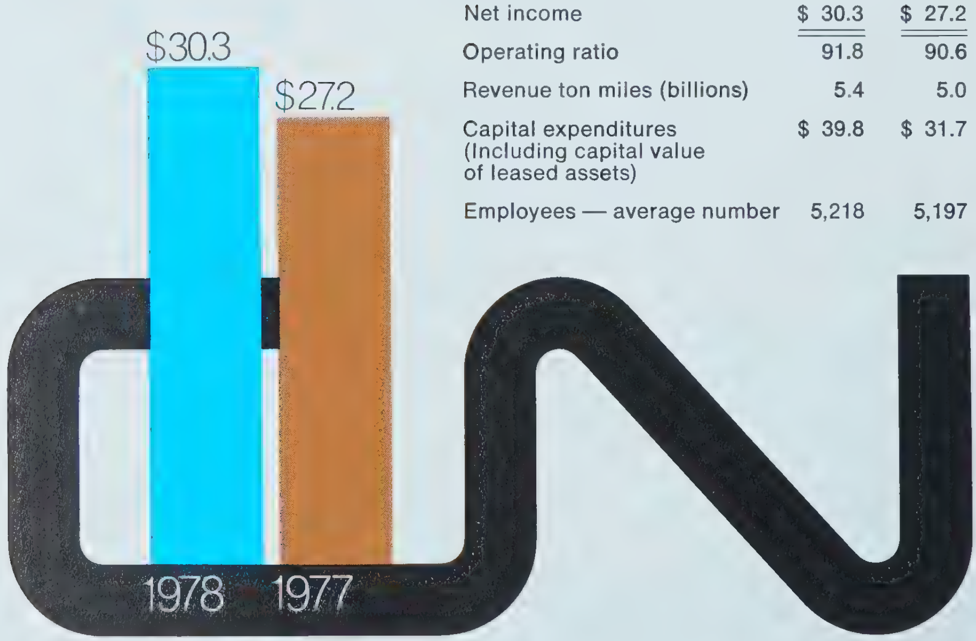
	1978	1977
Revenues	$ 99.8	$ 84.6
Expenses	320.9	295.7
Operating income (loss)	(221.1)	(211.1)
Government payments	165.0	161.2
Income (loss)	$ (56.1)	$ (49.9)
Employees — average number	2,529	2,766

Grand Trunk Corporation

Net income of the Grand Trunk Corporation (established in 1971 as the holding company for CN's wholly-owned U.S. railroad subsidiaries, the Grand Trunk Western, the Central Vermont, and the Duluth, Winnipeg and Pacific), was $30.3 million in 1978 compared with $27.2 million in 1977.

GRAND TRUNK CORPORATION
Highlights

	1978	1977
Revenues	$268.2	$232.2
Expenses	246.2	210.4
Operating income	22.0	21.8
Other income	10.6	6.8
Income before interest and income taxes	32.6	28.6
Interest on long-term debt	1.2	0.2
Income taxes	1.1	1.2
Net income	$ 30.3	$ 27.2
Operating ratio	91.8	90.6
Revenue ton miles (billions)	5.4	5.0
Capital expenditures (Including capital value of leased assets)	$ 39.8	$ 31.7
Employees — average number	5,218	5,197



The GTC continued its planned capital investment and plant maintenance programs. Expenditures covered the installation of continuous welded rail, increased ballasting and the acquisition of approximately 300 box cars.

During 1978, the GTC and its subsidiaries simplified their financial structures by eliminating the intracorporate debt.

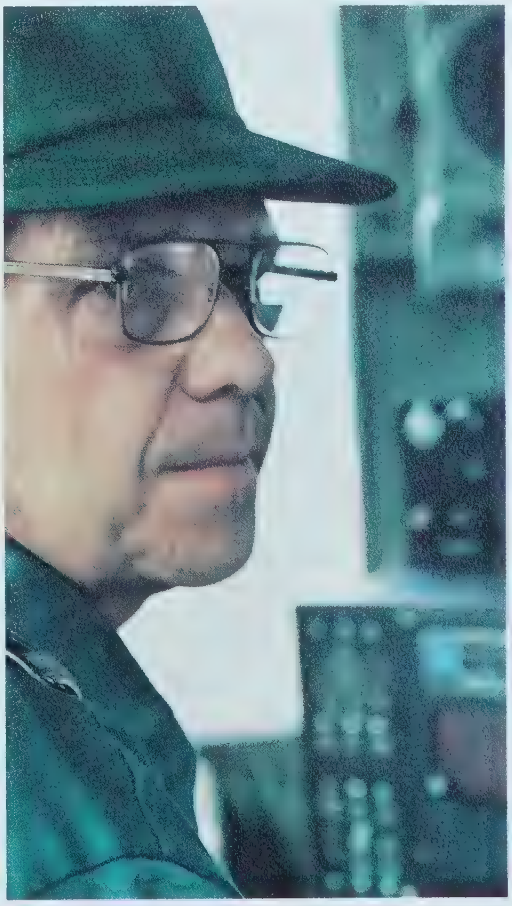
The GRAND TRUNK WESTERN, the largest of the GTC's operating companies had an income in 1978 of US $11.1 million, an increase of US $7.1 million over the previous year. This reflects reduced interest expenses resulting from the financial restructuring referred to above.

The CENTRAL VERMONT's 1978 income of US $2.1 million was a slight decrease from 1977 levels, attributable to heavier expenses incurred in track maintenance programs.

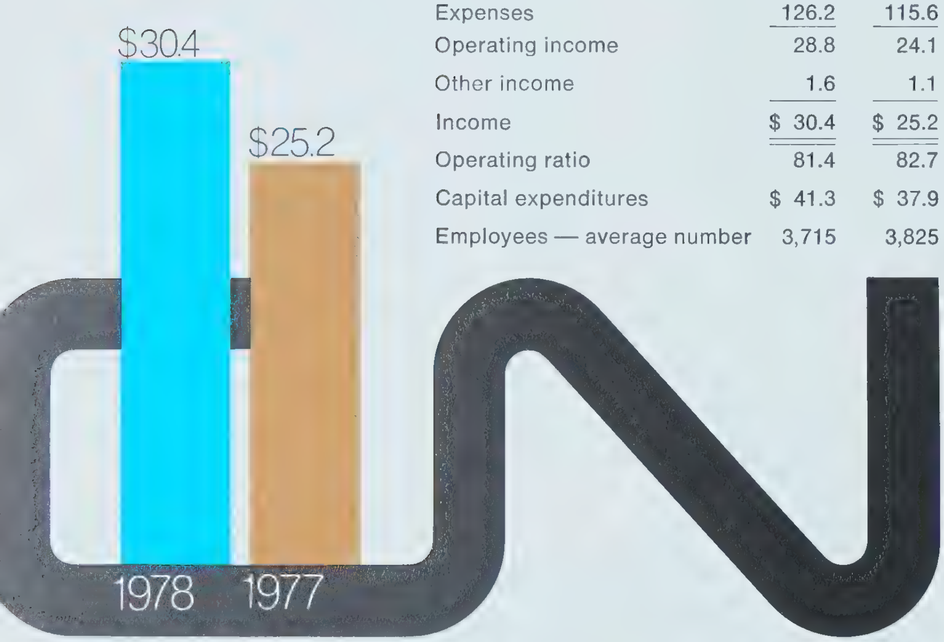
The revenues of the DULUTH, WINNIPEG AND PACIFIC increased by 8.5% to a new high of US $30.7 million. This was the third consecutive year in which record high revenues were achieved. Income in 1978 amounted to US $8.5 million, a moderate increase (1.2%) over 1977 levels.

In February 1978 the GTW filed a proposal with the Interstate Commerce Commission to acquire the Detroit, Toledo and Ironton Railroad. This proposed acquisition was filed in opposition to a joint application by the Chessie System and the Norfolk and Western to purchase control of the 478 mile railroad. In presenting its application to the Interstate Commerce Commission the GTW pointed out that the sale to the Chessie and Norfolk and Western had monopolistic implications and would weaken competition in the area. The DT&I, approximately one-half the size of the GTW, serves the states of Michigan and Ohio and would provide the GTW with a gateway to the south through Cincinnati.

A Grand Trunk Western locomotive engineer personifies the skill and experience needed to handle the trains of automobile carriers that make up an important part of traffic on the GTW.



CN Telecommunications



CN Telecommunications increased its income by more than 20% in 1978 through an 11% growth in revenues and an accompanying 9.2% increase in operating expenses. The result was a contribution of $30.4 million to the overall profit of Canadian National.

CN TELECOMMUNICATIONS
Highlights

	1978	1977
Revenues	$155.0	$139.7
Expenses	126.2	115.6
Operating income	28.8	24.1
Other income	1.6	1.1
Income	$ 30.4	$ 25.2
Operating ratio	81.4	82.7
Capital expenditures	$ 41.3	$ 37.9
Employees — average number	3,715	3,825

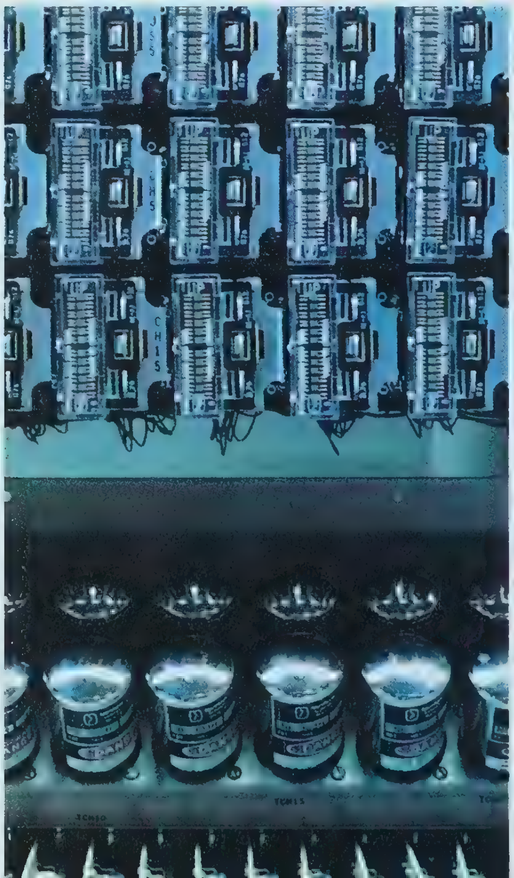
New services and an expanding market contributed to the growth in revenues while new technology improved productivity. Interruptions in postal service were responsible for some additional revenues.

The division was re-organized into three separate profit centres to provide more effective and market-responsive management. The three are the General Telecommunications Services Unit providing services in most of Canada in competition with the Trans-Canada Telephone System; the Northwest Telecommunications Unit, which provides services in the Yukon, the western Northwest Territories and northern British Columbia; and the Newfoundland Telecommunications Unit providing services in Newfoundland.

General Telecommunications Services Unit

This unit, in conjunction with Canadian Pacific Telecommunications, markets a wide range of telecommunications services to business and the public.

The continuing program of introducing the latest solid state technology has



contributed to improved productivity and a better operating ratio.

	1978	1977
Income	$ 19.6	$ 16.8
Operating ratio	81.2	82.2
Employees — average number	2,644	2,729

Northwest Telecommunications Unit

The Northwest Telecommunications Unit with headquarters in Whitehorse provides the public telephone service and a full range of modern telecommunications services in the western Canadian North. The computerized telephone toll center introduced at Whitehorse in December 1977 resulted in improved service to customers and significant savings in operating and maintenance costs. More than four million long distance telephone calls were completed in 1978, an increase of 18.1% over the previous year.

	1978	1977
Income	$ 8.2	$ 7.3
Operating ratio	77.0	76.7
Employees — average number	537	522

Newfoundland Telecommunications Unit

The Newfoundland Telecommunications Unit, which will have its headquarters at Gander, provides public telephone service in designated areas and a full range of modern telecommunications services throughout Newfoundland.

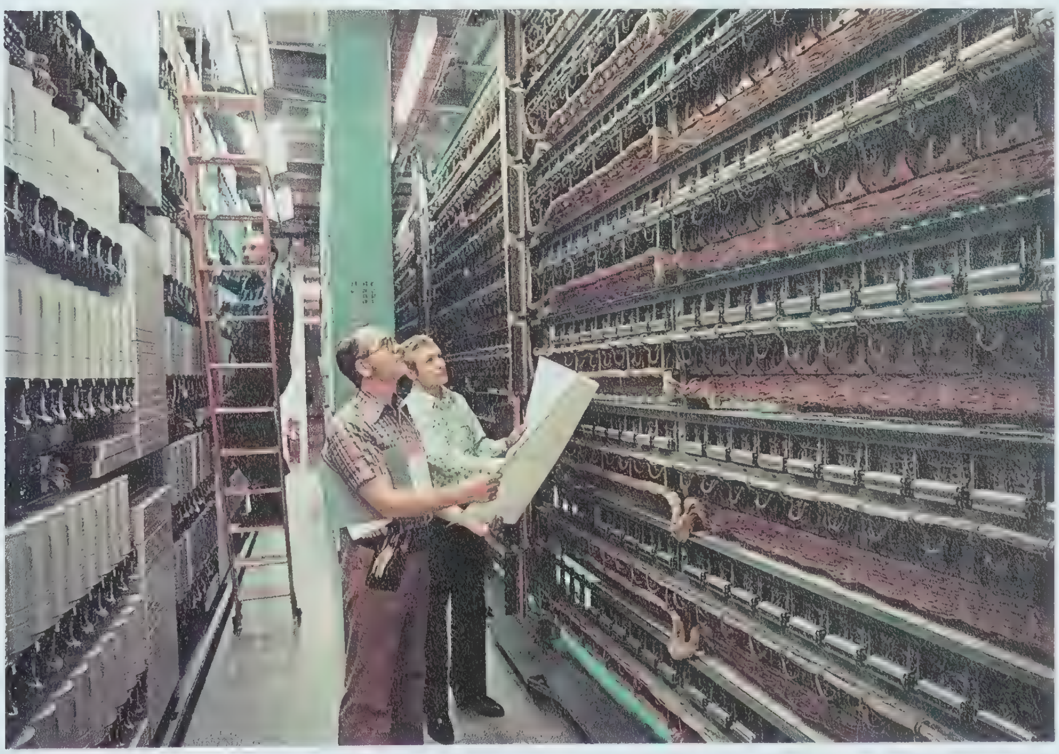
Increased marketing programs resulted in an 18.8% increase in long distance telephone calls over 1977 and the number of subscribers increased by 6%. As a result of a continuing program of improving service the percentage of telephone subscribers on one-party lines increased from 30% to 44% in 1978.

In addition to marketing efforts, rate increases granted by the Canadian Radio-television and Telecommunications Commission in the last half of the year contributed to the improved revenue picture in 1978.

	1978	1977
Income	$ 2.6	$ 1.1
Operating ratio	88.8	95.1
Employees — average number	534	574

(left) *Detail of electronic components in new telephone switching centre at Whitehorse, Yukon.*

(right) *Some of the CNT technical staff who operate and maintain the equipment at Whitehorse.*



CN Trucking

Despite a slow economy and severe competition from highway carriers and other modes of transport, CN Trucking showed a profit before tax of $3.2 million in 1978, up from $2.3 million in 1977.

CN TRUCKING
Highlights

	1978	1977
Revenues	$ 70.3	$ 72.6
Expenses	67.9	71.9
Operating income	2.4	0.7
Other income	0.8	1.6
Income before income taxes	$ 3.2	$ 2.3
Operating ratio	96.6	99.0
Capital expenditures	$ 6.9	$ 6.7
Employees — average number	1,679	1,883

The division has 10 active subsidiary companies with operations across Canada. The major portion of revenue is derived from the six Ontario based subsidiaries.

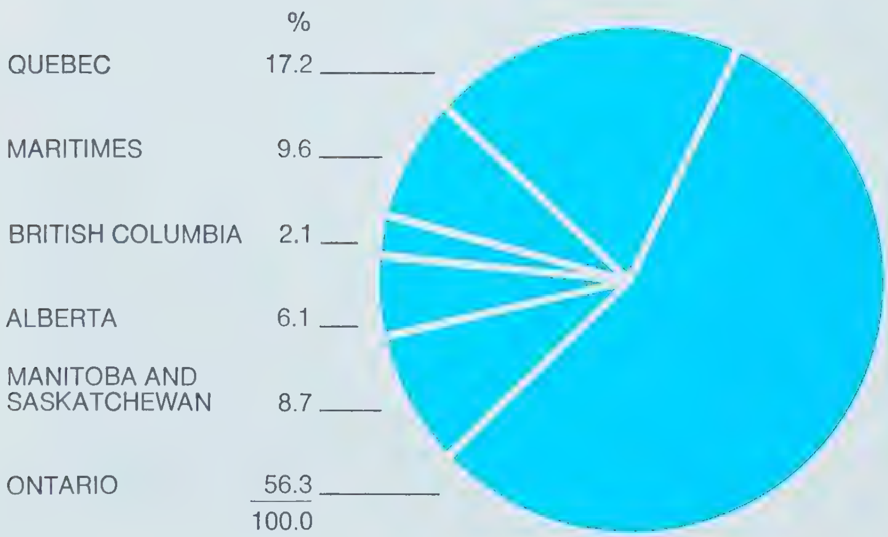
Revenues decreased slightly (by 3.2%) as compared to 1977, while expenses decreased by 5.6% because of effective cost controls and fleet reduction. The operating ratio decreased by 2.4% to 96.6 in 1978.

The most rewarding of the 1978 results has been the return to a profitable position of Husband Transport Limited, the largest of the operating subsidiaries. Husband's improved results were obtained through more effective use of line haul equipment and lower vehicle maintenance costs.

Capital expenditures for 1978 amounted to $6.9 million of which $6.1 million was for the replacement of equipment.

Trucking industry revenues generally increased during the last quarter of 1978. CN Trucking subsidiaries have benefitted significantly from this upturn which it is believed will continue through 1979.

DISTRIBUTION OF REVENUES
$70.3 million



CN Express

In 1978 effective marketing programs and cost-control programs were offset by wage and other inflationary cost increases. In consequence, the Express division lost $34.3 million in 1978 compared with $33.8 million in 1977.

CN EXPRESS
Highlights

	1978	1977
Revenues	$132.7	$132.8
Expenses	167.2	166.4
Operating income (loss)	(34.5)	(33.6)
Other income	0.2	(0.2)
Income (loss)	$ (34.3)	$ (33.8)
Operating ratio	126.0	125.3
Express shipments handled (thousands)	8,528	7,473
Capital expenditures	$ 6.9	$ 13.4
Employees — average number	5,541	5,831

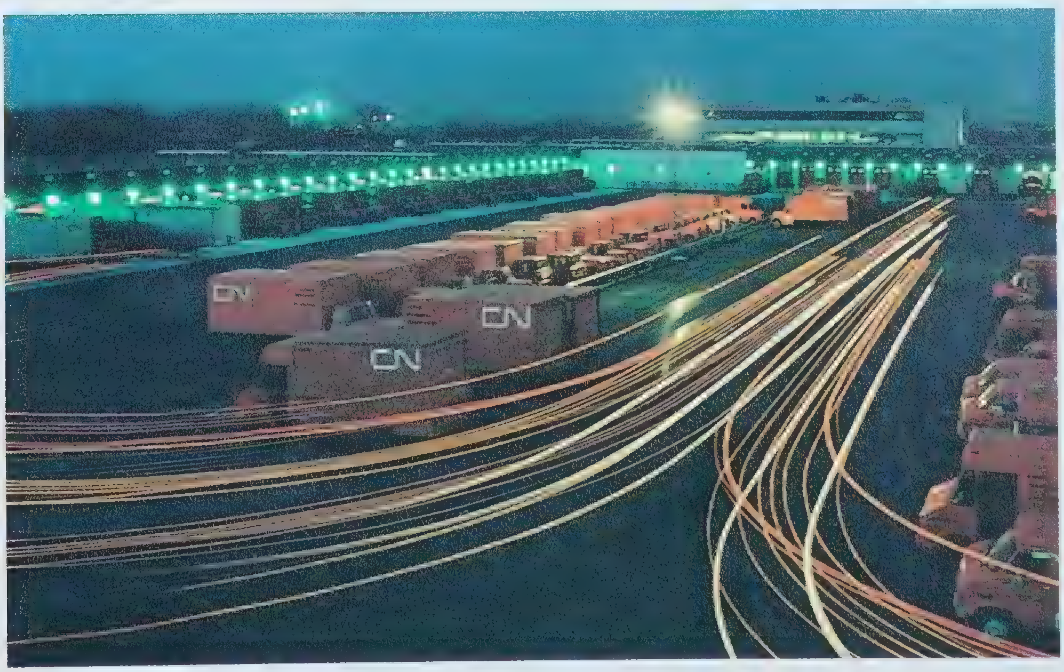
While poor economic conditions and severe competition continued to affect the Express business there was an encouraging improvement in Rapidex revenues. Capital expenditures were reduced in 1978 with expenditures on equipment being largely limited to replacements. Most of the expenditure for facilities involved the completion of the new Lachine, Quebec terminal which was opened in July.

Capital Expenditures

	1978	1977
Facilities	$ 2.6	$ 5.1
Equipment	4.3	8.3
	$ 6.9	$13.4

While current operating results are not encouraging, divisional management has embarked on a selective marketing/operating program designed to improve results by increasing traffic in profitable, high density areas, adjusting prices to make use of capacity and curtailing unprofitable activities.

In 1979 the division expects productivity improvements to be achieved through further terminal consolidations and through the use of information provided from the on-line computer system, TRACE (Traffic Reporting and Control for Express) which is under development.



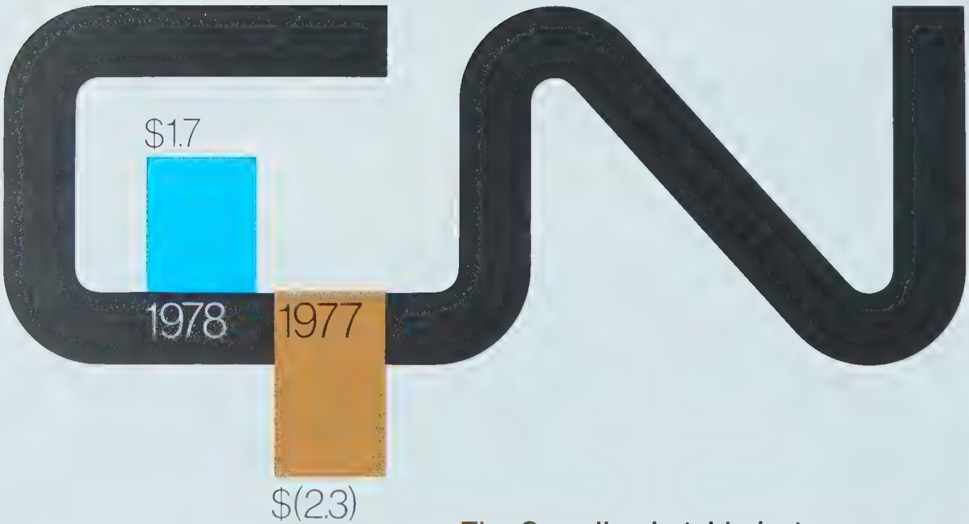
This new CN Express terminal at Lachine, Que., has replaced an older facility in downtown Montreal.

CN Hotels

In 1978 the CN Hotels division, which includes two Hilton-operated hotels and the Place Ville Marie restaurants, showed a profit of $1.7 million compared with a loss of $2.3 million in 1977. The seven CN-operated hotels and CN Tower Restaurants Ltd. contributed $1.9 million to the 1978 results, an increase of $2.2 million over 1977.

CN HOTELS
Highlights

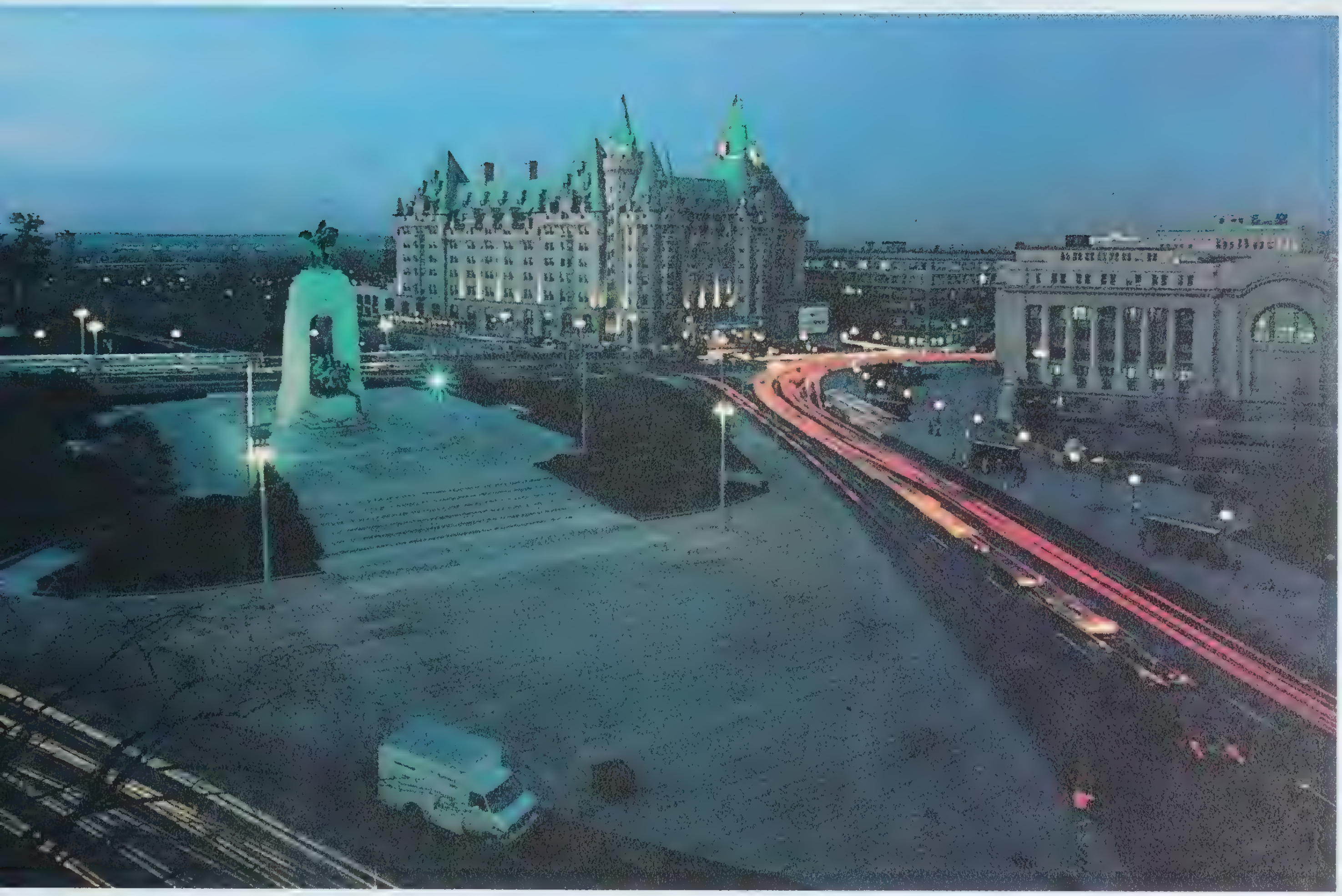
	1978	1977
CN Operated		
Revenues	$ 46.0	$ 42.5
Expenses	42.8	41.5
	3.2	1.0
Divisional expenses	1.3	1.3
Income (loss)	1.9	(0.3)
Hilton Operated		
Income (loss)	(0.2)	(2.0)
Total income (loss)	$ 1.7	$ (2.3)
Operating ratio - CN operated	95.9	100.7
Capital expenditures	$ 4.9	$ 4.0
Employees — average number	1,154	1,179



It takes a variety of skills and experience to run a great hotel. In the lobby of CN's Chateau Laurier, General Manager Harry Dugal (seated) and some of his key staff: Ann Lodge, convention coordinator; Rod Nolan, banquet manager; Jimmy Belle, chef de cuisine; Pasquale Zito, head waiter, Canadian Grill.

The Canadian hotel industry as a whole achieved higher occupancies in most areas. Oversupply of hotel rooms is still an industry problem in some cities, however, as is the adverse effect of restrictive U.S. taxation rulings on American convention travel in foreign countries.

Revenues of the CN-operated hotels increased 8.2% over the previous year.



CN's historic Chateau Laurier, a thoroughly modernized "Grand Hotel" has long been part of the ambiance of Ottawa.

The improvement resulted mainly from the increase in occupancies and higher room rates. Expenses increased only 3.1% reflecting effective control over operating costs.

Particularly noteworthy was the improvement in the results for the CN Tower Restaurants, where a $1.0 million loss in 1977 was turned into a break-even position in 1978.

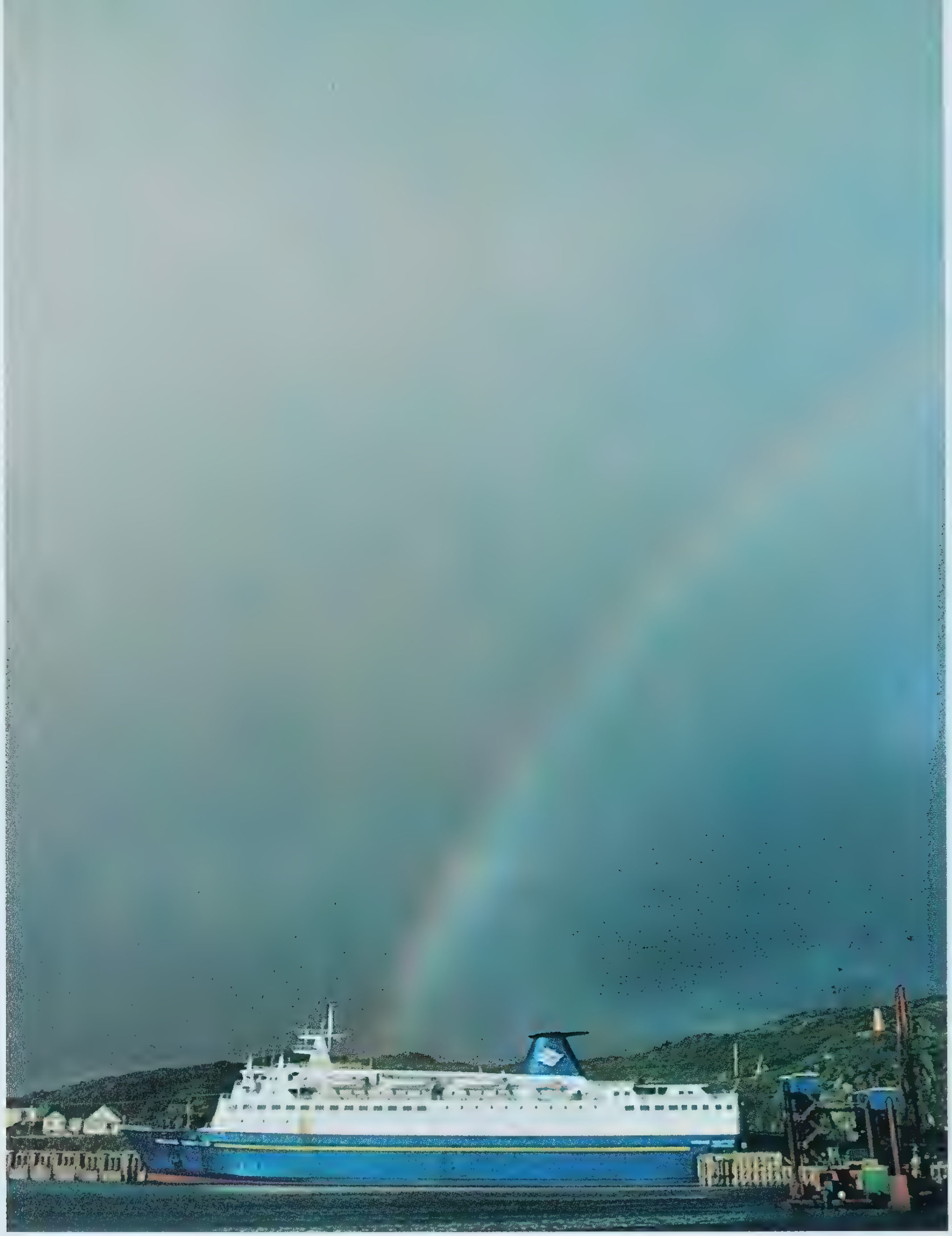
Hilton-operated properties showed a $1.8 million improvement over 1977 largely because of improved performance at the Queen Elizabeth Hotel and at the Hotel Vancouver. The latter had been adversely affected by a 42-day strike in June/July 1977. Despite the improvement, the overall financial result was disappointing.

Capital expenditures in 1978 amounted to $4.9 million primarily for the maintenance and upgrading of hotel properties. Expenditures were for additions and replacements of furnishings and equipment generally and to improve recreational facilities at Jasper Park Lodge.

Programs are currently being developed to improve both the quality and profitability of all elements of CN Hotels.

During 1978 construction was started on a 105 room extension to the CN managed Hotel Beauséjour in Moncton. Construction is expected to be completed in mid-1979. The 50% increase in room availability should contribute substantially to the future earnings of CN Hotels.

An extensive renovation program for the Place Ville Marie Restaurants will be completed in early 1979.




UYBF

CN Marine

The CN Marine division is responsible for the operation and administration of most of Canadian National's marine activities including those services which are fully subsidized by the Government of Canada (Atlantic Ferry & Coastal Services) or the Government of New Brunswick (Grand Manan Services).

In addition to the ferry services, CN Marine operates a ship repair yard and dry dock facility at St. John's which performs refit work for the vessel operation of the Marine division and undertakes work on a commercial basis for vessels operating in the northwest Atlantic.

Subsidized Services

During 1978, Canadian National continued negotiating with the Federal Government to assume full responsibility for the operation of the Atlantic Ferry & Coastal Services. Although the final agreement has not been signed it is anticipated that from 1979 onwards these services will contribute to Canadian National's profitability.

Extensive conversions were completed on the Sir Robert Bond to enable this ship to carry passengers as well as freight on the Newfoundland-Labrador routes. This change makes possible its use as a replacement vessel on the Bay of Fundy during periods in which the existing vessel is out of service. To improve customer service, steps have been taken towards the establishment of an automatic reservation system for passengers.

Steps were taken to assess both volume and configuration of Newfoundland traffic into the next decade. It is anticipated that the ultimate result will be the replacement of the Nautica class ferries on the Gulf Service.

Design work was completed for a new ship to replace the thirty-one year old Abegweit on the high-volume Prince Edward Island Service. The new ship will provide double the capacity and horse-power of the existing vessel. Extensive terminal conversions will be required at Borden and Cape Tormentine.

During 1978, CN Marine acquired Coastal Transport Limited of Saint John which operates ferry services between the New Brunswick mainland and the Island of Grand Manan on behalf of the New Brunswick Government.

Non-Subsidized Services

The Newfoundland Dockyard at St. John's worked on 279 vessels, a 13.4% increase over 1977.

The dockyard may benefit during the coming year from a federal program to boost employment in the area. The program would involve the construction of a ship elevator and three repair berths at the yard. This new facility should place the dockyard in a profitable position.

During 1978, an international consortium of which CN Marine is a partner purchased the Halifax Shipyard and Dartmouth Marine Slip. A new management team has been assembled with the purpose of revitalizing and modernizing this facility in order to attract repair work to the yard.

CN MARINE
Highlights

	1978	1977
Subsidized services		
Revenues	$ 22.6	$ 20.3
Expenses	117.9	114.9
	(95.3)	(94.6)
Government subsidies	95.3	94.6
	—	—
Other	(0.1)	—
Income (loss) before interest	(0.1)	—
Interest on long-term debt	(0.1)	—
Income (loss)	$ (0.2)	$ —
Traffic statistics (thousands)		
Passengers	2,129	2,057
Passenger related vehicles	654	638
Commercial vehicles	229	201
Railcars	46	50
Employees — average number	3,469	3,590

Note:
Statistics for Yarmouth/Bar Harbor, Yarmouth/Portland and Grand Manan services are not included above.

Top: *CN Marine ferry Marine Cruiser at Port aux Basques.*
Bottom left: *A Russian fishing trawler is in CN's drydock in St. John's, Nfld. The captain of the ship goes over repair plans with drydock staffers.*
Bottom right: *Officers on the bridge of CN Marine vessel on Borden-Cape Tormentine run.*

Consulting Activities

CANAC Consultants Limited, the international consulting arm of Canadian National, earned an income of $0.3 million in 1978 compared with $0.4 million in 1977.

In 1978 CN marked the 10th anniversary of its formal entry into the international consulting business. In the 10 year period CANAC and its predecessor, the International Consulting Division (ICD), have marketed their services on five continents and provided CN with income totalling more than $3.5 million.

A highlight of 1978 was the signing near year-end of an Agreement with the Venezuelan Railway Institute.

Canaven, a Canadian National owned subsidiary, joined with Spanish and Venezuelan consortia, in signing this Agreement, which will govern contracts to be negotiated for the construction and commissioning of a new 700 km railway line in Venezuela. CANAC will have major participation in these contracts.

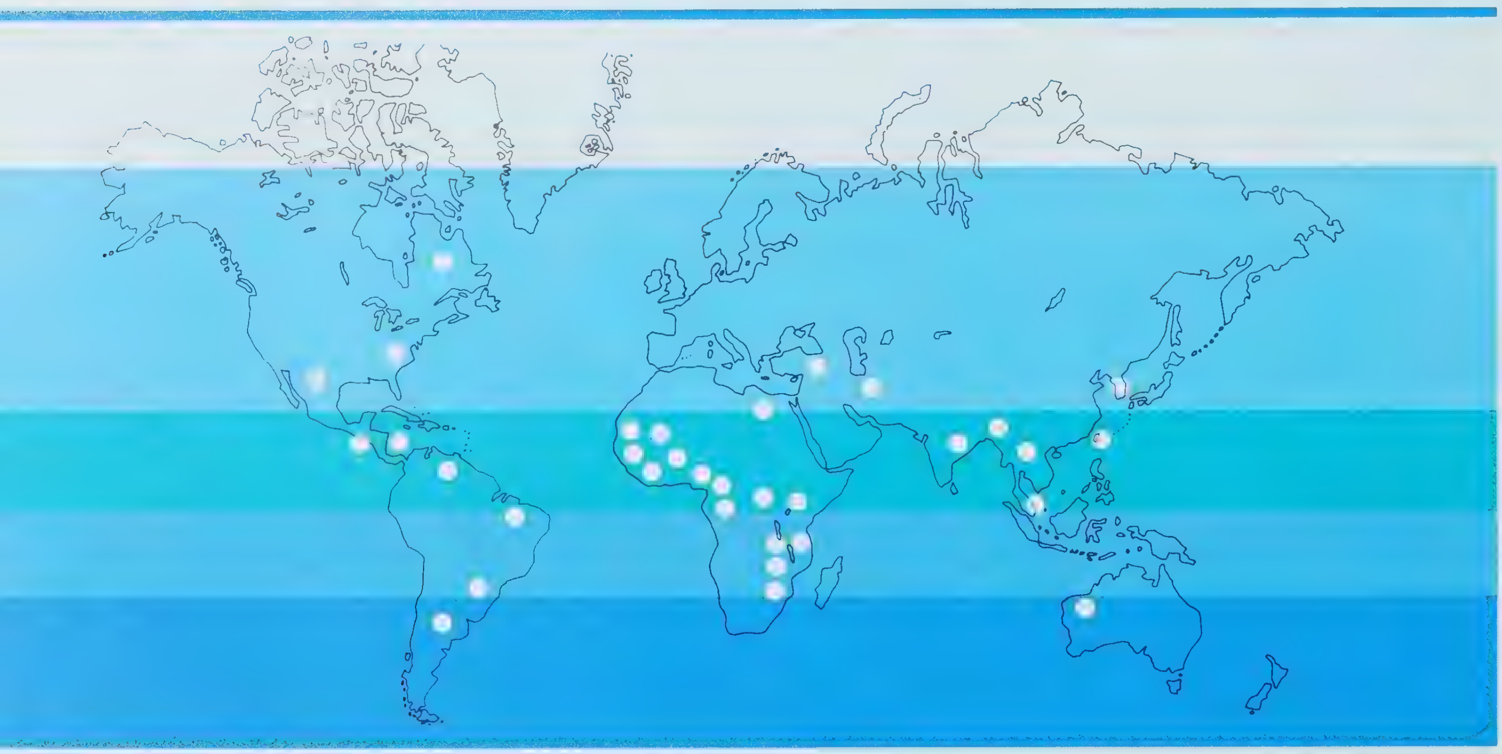
Canaven entered into a contract with Industrial Europeas C.A. for the latter firm to provide services as a commercial representative. No remuneration is yet due to this firm.

CANAC entered a new business area with the signing of several contracts related to the procurement of Canadian-built locomotives, freight cars, and other equipment and supply for railways in Africa, Asia and North America.

Considerable development work was devoted to Middle East countries where there is great potential for railway development. Three important proposals were submitted in this market area in 1978 and were still under consideration at year-end. In connection with these proposals CANAC is represented by Rasim Sha'ath in Saudi Arabia and Redec (Canada) Research and Development in Jordan and Syria. No remuneration is yet due these representatives.

In concert with other Canadian consultants, a significant management contract proposal was submitted to rail management in the Ivory Coast. At year-end contract negotiations were close to finalization.

CANAC and ICD projects around the world.



Corporate Headquarters

Corporate headquarters provided support services to the operating divisions in many areas. Departments such as the Secretary's Office, Law, Public Affairs, Management Services, Comptroller's Office, Treasurer, Police, Medical Services, Corporate Planning, Purchases and Materials Management, Costing and Economics Research, Industrial Relations and Organization, and Real Estate all played a vital role in providing expertise for System operations.

The appointment for the first time of a Vice-President, Real Estate, reflects the growing importance of this activity which in 1978 contributed $24.8 million to CN income. This represents an improvement of $15.8 million over 1977 and arose principally from the sale of property in Toronto to the Canadian Broadcasting Corporation.

As part of continuing development of computer usage, Management Services was involved in a number of important programs during 1978. These included installation of the first phase of TRACE, the computerized system for the reporting and control of Express shipments and equipment. They also included implementation of BERMS (Basic Engineering Reporting Management System) which will eventually provide better engineering information for management.

Installation of computerized inventory control for cars in hump yards was extended to the Donald Gordon Yard in Moncton in conjunction with CN Rail Research. This system, which permits significant productivity improvements in these major yards, is being modified for use in smaller flat yards where similar cost reductions are expected.

A new computer centre in Fort Rouge, Manitoba became operational in 1978, with primary purpose to provide back up for the TRACS system. It is expected the project will be completed in early 1979.

Another highlight of the year was the coming into full operation of CN's new warehouse complex in Winnipeg. This complex is among the most advanced and sophisticated facilities of its kind in North America. It eliminates many manual handling practices and also permits the loading and unloading of railcars and highway vehicles in a weather-protected environment. This new complex will provide improved working conditions and save CN over $1 million annually.

CN's People

A one year agreement covering 58,000 employees was signed with the Associated Railway Unions in January, 1978. During the year, an extensive round of collective bargaining was entered into relating to the transfer of employees to VIA Rail Canada Inc. With the assistance of a federally-named mediator-arbitrator, agreements were concluded and signed in the early part of July.

A highlight in labour relations was the agreement reached between Canadian National and the United Transportation Union discussed on Page 8. In addition to protecting existing employees the agreement also provides for the sharing of payroll savings between the employees and CN during the first 10 years of the program. This agreement

demonstrates that technological change situations can be resolved to the mutual benefit of all parties.

In the latter part of the year, national labour negotiations began with railway unions for the renewal of collective agreements which expired on December 31, 1978. At year-end, negotiations with each of the four major bargaining groups were progressing well.

During 1978, considerable progress was made on programs to develop the people who will manage CN in the future. As part of the development activity, 36 CN officers attended a four-week in-residence program sponsored by CN at Bishop's University. Because of the excellent results a second program will be conducted in mid-1979.

Canadian National's suggestion plan, designed to assist in the reduction of costs, to increase productivity, and help to eliminate wasteful practices produced annual net savings for the Company of approximately $170,000 in 1978.

A total of 43,923 pensioners and beneficiaries under various CN pension arrangements received $148.9 million in 1978 compared with 42,920 pensioners and beneficiaries receiving $133.9 million in 1977.

The adoption of a revised policy on official languages in 1977 provided that the planning of new computer facilities take into consideration the need for capability in both official languages. In addition to translating manuals of instruction for TRACS permitting employees to work in the official language of their choice, efforts have begun to consider the use of both official languages in older computer systems. The revised policy on bilingualism is also being applied to the computerized Mainstores Master Catalogue of Parts. This catalogue of over 115,000 parts is being translated by Linguistic Services and Purchases and Materials Management and it is planned to have bilingual parts catalogues available in 1980.

A technician at CNT headquarters in Toronto, Danny Wu, came up with a new idea for CN's 1978 Suggestion Program; and came away with a $6,300 award.

Consolidated Financial Statements

Consolidated Balance Sheet

		December 31			
			1978		1977
Assets			(in thousands)		
Current Assets	Cash		$ 4,405		$ 39,898
	Accounts receivable		373,784		318,029
	Material and supplies		236,391		244,699
	Other current assets		111,490		88,275
			726,070		690,901
Insurance Fund			18,191		15,188
Investments			68,443		415,553
Property Investment			3,628,287		3,498,342
Other Assets and Deferred Charges			90,157		55,695
			$4,531,148		**$4,675,679**
Liabilities					
Current Liabilities	Bank loans		$ 2,400		$ 109,500
	Accounts payable		307,456		243,967
	Accrued charges		145,280		166,020
	Other current liabilities		113,572		69,975
			568,708		589,462
Provision for Insurance			18,191		15,188
Other Liabilities and Deferred Credits			124,499		114,175
Long-Term Debt			1,322,265		1,568,253
Capital Stock of Subsidiary Companies Owned by Public			4,345		4,345
Shareholder's Equity	Capital stock of Canadian National Railway Company; 6,000,00 common shares of no par value authorized, issued and outstanding	$2,344,474		$2,344,474	
	Retained earnings	148,666	2,493,140	39,782	2,384,256
			$4,531,148		**$4,675,679**

On behalf of the board:
J. A. Dextraze, Director
R. A. Bandeen, Director

See accompanying notes to consolidated financial statements.

Consolidated Statement of Income

		Year ended December 31			
			1978		1977
			(in thousands)		
Revenues			$2,870,348		$2,612,057
Expenses			2,686,492		2,446,173
Operating income			183,856		165,884
Other income			48,826		18,196
Income before interest, income taxes and extraordinary item	CN Rail	$257,141		$206,717	
	Grand Trunk Corporation	32,577		28,560	
	CN Telecommunications	30,444		25,194	
	CN Trucking	3,232		2,301	
	CN Express	(34,274)		(33,801)	
	CN Passenger	(56,083)		(49,854)	
	CN Hotels	1,682		(2,255)	
	CN Marine	(122)		—	
	Miscellaneous	(1,915)	232,682	7,218	184,080
Interest	Interest on long-term debt, less interest received on loans to Air Canada		99,262		149,021
	Net interest on short-term (investments) borrowings		(4,108)		5,755
			95,154		154,776
Income before income taxes and extraordinary item			137,528		29,304
	Income taxes		55,395		12,500
Income before extraordinary item			82,133		16,804
	Reduction in income taxes on application of prior years' losses		53,972		11,214
Net income			**$ 136,105**		**$ 28,018**

See accompanying notes to consolidated financial statements.

Consolidated Statement of Retained Earnings

	Year ended December 31	
	1978	1977
	(in thousands)	
Balance, beginning of year	$ 39,782	$11,764
Net income for the year	136,105	28,018
	175,887	39,782
Dividend	27,221	—
Balance, end of year	**$148,666**	**$39,782**

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Financial Position

		Year ended December 31 1978	1977
		(in thousands)	
	Working Capital, beginning of year	**$101,439**	**$ 25,255**
Funds Provided	Net income for the year	136,105	28,018
	Add (deduct) items not involving the current provision or use of funds		
	—depreciation	166,240	165,023
	—equity in net income of companies accounted for by equity method, less dividends received	(2,128)	(79)
	—amortization of discount on long-term debt	793	845
	—other	12,711	27,319
	Funds from operations	313,721	221,126
	Issuance of long-term debt	151,372	240,948
	Net proceeds from disposal of assets	78,772	16,630
	Sale of rolling stock purchased in prior year, sold and leased back in current year	—	5,419
	Cancellation of Air Canada shares and debt	349,477	—
	Sale of VIA Rail Canada Inc. shares	100	—
	Increase in capital stock on conversion of long-term debt	—	808,000
	Sale of 4% preferred stock	—	51,449
	Repayments of advances by jointly-operated companies	—	2,096
	Total Funds Provided	**893,442**	**1,345,668**
Funds Used	Additions to property investment	374,957	372,658
	Balance of sale of assets	36,849	—
	Dividend	27,221	—
	Investment in jointly-operated and other companies	339	815
	Discount on issuance of bonds	—	450
	Reduction of long-term debt		
	—conversion to capital stock	—	808,000
	—cancellation of debt equivalent to Air Canada shares and debt	349,477	—
	—other	48,676	87,561
	Total Funds Used	**837,519**	**1,269,484**
Increase in Working Capital		55,923	76,184
	Working Capital, end of year	**$157,362**	**$101,439**

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

NOTE 1: Summary of Significant Accounting Policies

Introduction
All references in these Notes to the "Company" include the Canadian National Railway Company and its consolidated subsidiaries, and all references to the "System" mean Canadian National Railway Company and its consolidated subsidiaries together with the lines of railway and marine, telecommunications and other property entrusted by the Government of Canada to the Company for management and operation.

a. Principles of Consolidation
The consolidated financial statements include the accounts of all subsidiaries and, consistent with the legislation governing the System, the accounts of the Canadian Government Railways entrusted to the Company by the Government of Canada.

Investments in jointly-operated companies in which the Company has less than a majority interest are accounted for by the equity method where appropriate.

b. Material and Supplies
The inventory has been priced at laid down cost based on weighted average cost for ties and rails, latest invoice price for fuel and new materials in stores, and at estimated utility or sales value for usable second hand, obsolete and scrap materials.

c. Insurance Fund
The System is self-insured for various risks, maintaining a separately invested fund. The provision for insurance represents the estimated amount of self-insured losses to be adjusted.

d. Property
Property is carried at cost, which, in the case of properties brought into the System at January 1, 1923, is the aggregate of the values then appearing in the books of the railways now comprised in the System, less a write-down of $262.8 million at the time of capital revision in 1937. Accounting for railway and telecommunications property is carried out in accordance with rules issued by the Canadian Transport Commission and the Canadian Radio-television and Telecommunications Commission respectively (Canadian property), and the Interstate Commerce Commission (United States property), except, in the case of United States property, for the application of depreciation accounting to ties, rails, other track material and ballast as referred to below under Depreciation. Major additions and replacements generally are capitalized with the exception of labour costs relating to track material replacement which are charged to expense.

The cost of depreciable assets retired or disposed of, less salvage, is charged to accumulated depreciation, in accordance with the group plan of depreciation.

e. Depreciation
Depreciation is calculated at rates sufficient to write off properties over their estimated useful lives, generally on a straight-line basis in accordance with the group method. For railway and telecommunications properties, certain rates are authorized by the Canadian Transport Commission, the Canadian Radio-television and Telecommunications Commission and the Interstate Commerce Commission. The rates for significant classes of assets are as follows:

	Annual Rate
Ties	3.25%
Rails	1.15%
Other track material	1.90%
Ballast	4.00%
Road locomotives	4.60%
Freight cars	2.97%
Commercial communication systems	4.27%

f. Pensions
Current service costs are charged to operations, and funded, as they accrue.

Prior service costs are charged to operations over varying periods to 2027, as set out in Note 8, and are being funded by annual payments covering principal and interest over varying periods to 2006 (2014 in the case of U.S. Plans) as permitted by regulatory authorities.

g. Foreign Exchange
Assets and liabilities in foreign currencies have been translated into Canadian dollars at current rates except for investments, property investment and long-term debt for which historical rates have been used. Income is charged or credited with all exchange differences. Income and expenses of foreign subsidiaries have been translated at average rates during the year except for depreciation provisions which are on the same basis as the related property investment.

NOTE 2: Investments

		Percentage of Ownership	December 31 1978	1977
			(in thousands)	
Jointly-operated companies, on equity method where appropriate, or at cost less provision for any impairment in value	Chicago & Western Indiana Railroad Company	20%	$ 7,104	$ 7,138
	The Detroit & Toledo Shore Line Railroad Company	50%	5,933	5,786
	Northern Alberta Railways Company	50%	27,721	25,908
	The Toronto Terminals Railway Company	50%	9,182	9,182
	Other		6,503	5,962
			56,443	53,976
Other companies, at cost	Eurocanadian Shipholdings Limited	18%	11,900	11,900
	Intercast S.A.	18%	100	100
			12,000	12,000
Unconsolidated wholly-owned subsidiaries, at cost	**Air Canada** Under authority of the Air Canada Act, 1977, and Order-in-Council P.C. 1978-1172 dated April 13, 1978, the Company divested itself of its investment in Air Canada and an equivalent amount of Company debt to the Government of Canada was cancelled.		—	349,477
	VIA Rail Canada Inc. During 1978, the Company's investment in VIA Rail Canada Inc. was disposed of at book value to the Government of Canada.		—	100
	Total		**$ 68,443**	**$415,553**

NOTE 3: Property Investment

	December 31, 1978			December 31, 1977		
	Cost	Accumulated Depreciation	Net	Cost	Accumulated Depreciation	Net
	(in thousands)					
Railway						
Canadian Lines (1)	$5,089,223	$2,229,615	$2,859,608	$5,043,402	$2,257,996	$2,785,406
Grand Trunk Corporation	378,565	121,099	257,466	351,218	124,065	227,153
	5,467,788	2,350,714	3,117,074	5,394,620	2,382,061	3,012,559
CN Telecommunications	494,295	164,065	330,230	461,327	151,344	309,983
CN Trucking	51,663	23,951	27,712	49,497	23,155	26,342
CN Hotels	122,666	55,322	67,344	118,538	51,690	66,848
Other	95,970	10,043	85,927	90,282	7,672	82,610
	764,594	253,381	511,213	719,644	233,861	485,783
	$6,232,382	**$2,604,095**	**$3,628,287**	**$6,114,264**	**$2,615,922**	**$3,498,342**
Amounts included above with respect to Canadian Government Railways entrusted to the Company by the Government of Canada and estimated accumulated depreciation	$ 820,316	$ 423,165	$ 397,151	$ 782,565	$ 424,800	$ 357,765

(1) Includes CN Rail, CN Express, CN Passenger and CN Marine properties.

NOTE 4: Long-Term Debt

	Maturity	Currency in which payable	December 31 1978	1977
	(in thousands)		(in thousands)	
Bonds and Debentures				
Canadian National 4% 23 Year Bonds (a)	Feb. 1, 1981	Canadian	$ 300,000	$ 300,000
Canadian National 5¾% 25 Year Bonds (a, b)	Jan. 1, 1985	Canadian	74,467	76,867
Canadian National 8⅜% 10 Year Bonds	Nov. 15, 1986	U.S. $85,000	83,232	83,232
Canadian National 8⅞% 10 Year Bonds (b)	Mar. 1, 1987	Canadian	54,600	57,000
Canadian National 5% 27 Year Bonds (a, b)	Oct. 1, 1987	Canadian	117,782	121,532
Canadian National 9¼% 20 Year Sinking Fund Debentures (b)	Mar. 15, 1998	U.S. $120,000	133,533	—
Canadian National 8⅜% 25 Year Sinking Fund Debentures (b)	July 1, 2002	U.S. $100,000	105,935	105,935
Buffalo and Lake Huron 5½% 1st Mortgage Bonds	Perpetual	Sterling	795	795
Buffalo and Lake Huron 5½% 2nd Mortgage Bonds	Perpetual	Sterling	1,228	1,228
Total Bonds and Debentures			871,572	746,589
Government of Canada Loans and Advances (c, d)				
Government of Canada consolidated loan (d)		Canadian	252,875	—
Canadian Government Railways advances for working capital		Canadian	16,984	16,984
Financing and Guarantee Acts loans		Canadian	—	250,860
Refunding Act, 1955 loans for debt redemption		Canadian	—	1,069,118
Loans for capital expenditures		Canadian	—	128,492
Government loans converted to equity (d)			—	(808,000)
Amounts included in current liabilities			(5,244)	(11,486)
Total Government of Canada Loans and Advances			264,615	645,968
Other				
Amounts owing under equipment purchase agreements (e)		U.S. $192,046 (1977 - $185,699)	194,197	186,050
Promissory Note 9⅝% (f)			2,681	—
Amounts included in current liabilities			(7,842)	(6,603)
Total Other			189,036	179,447
			1,325,223	1,572,004
Less: Unamortized discount on long-term debt			2,958	3,751
Long-Term Debt			**$1,322,265**	**$1,568,253**

a.
Guaranteed by the Government of Canada.

b.
It is a condition of the 5¾% bonds due in 1985 and the 5% bonds due in 1987, that the Company will use its best efforts to purchase during each quarter of each calendar year to maturity when available in the open market at prices not greater than their respective original issue prices, at least ½ of 1% of the principal amount of the issue.

It is a condition of the 8⅞% bonds due in 1987 that the Company will use its best efforts to purchase bonds during each of the following years and in the aggregate principal amounts set forth below, in each case at a price not exceeding the offering price (99¼):

During each year commencing March 1	Principal Amount
1979	$1,800,000
1980-1986	1,200,000

For the 9¼% sinking fund debentures due in 1998, there is a mandatory sinking fund provision under which the Company will pay, before March 15, 1984, and each year thereafter to and including March 15, 1997, a sum in cash sufficient to retire on each such March 15 U.S. $8,000,000 principal amount of debentures at 100% of their principal amount.

For the 8⅜% debentures due in 2002, there is a mandatory sinking fund provision under which the Company will pay before July 1, in each of the years 1983 to 2001 inclusive, an amount sufficient to redeem U.S. $5,000,000 principal amount of debentures at 100% of their principal amount or deliver to the sinking fund debentures otherwise acquired of equivalent principal amount.

c.
Weighted average interest rate on Government of Canada loans and advances outstanding at December 31, 1978, was approximately 8.2% per annum (1977 - 7.7%).

d.
Under Orders-in-Council Nos. P.C. 1978-3051 and P.C. 1978-3052 dated October 4, 1978, pursuant to legislation referred to in Note 5 (a), the Company received authority to convert to equity, effective December 31, 1977, particular debts to the Government amounting to $808 million and to consolidate into one debt, effective June 30, 1978, all the remaining debt of the Company to the Government, except the Canadian Government Railways advances for working capital. The debt so consolidated bears interest at 8.75% per annum calculated from July 1, 1978, and is payable over twenty years to June 30, 1998, in equal semi-annual payments of $13.63 million covering principal and interest. (See Note 2 regarding cancellation of $349.477 million of debt to the Government, equivalent to the Company's former investment in Air Canada and Note 5 (a) regarding restatement of certain comparative figures as at December 31, 1977.)

e.

Secured by rolling stock and payable by principal instalments in U.S. dollars, as follows:

Principal outstanding December 31, 1978	Semi-annual Instalment	Period From	Period To	Annual Interest Rate
(in thousands of U.S. dollars)				
$ 6,000	$1,200	January 1979	January 1981	9.00%
38,000	1,900	July 1981	January 1991	9.75%
49,862	2,493	July 1981	January 1991	9.75%
9,400	940	January 1979	July 1981	8.50%
	1,880	January 1982	July 1982	
7,044	704	January 1979	January 1982	8.00%
	1,409	July 1982	January 1983	
33,840	1,880	January 1983	July 1991	9.00%
25,355	1,409	July 1983	January 1992	8.50%
2,873	Various*	May 1979	November 1989	8.125%
6,853	245	June 1979	December 1992	8.625%
2,430	Various*	April 1979	April 1992	8.50%
1,050	Various*	June 1979	December 1993	9.375%
5,355	179	April 1979	October 1993	8.875%
1,875	125	June 1979	June 1986	9.00%
1,304	43	July 1979	January 1994	9.25%
	Quarterly Instalment			
805	67	January 1979	July 1981	8.35%
$192,046				

**Repayable by semi-annual instalments of $200,000, $150,072 and $65,890 respectively, representing blended payments of principal and interest.*

f.

Repayable by semi-annual instalments of $218,503, including principal and interest, from August 1, 1979 to August 1, 1988.

g.

Principal amounts due in the years indicated on debt outstanding at December 31, 1978, are as follows:

Year ending December 31:	Principal amount maturing (in thousands)
1979	$ 20,214
1980	20,274
1981	323,934
1982	32,142
1983	39,561
1984 - 1988	498,111
1989 - 1993	193,228
1994 - 1998	170,655
1999 - 2002	21,183

NOTE 5: Shareholder's Equity

a. Capital Stock

On June 30, 1978, "an Act to amend the Canadian National Railways Capital Revision Act and the Railway Act and to amend and repeal certain other statutes in consequence thereof" came into force. This Act has, as of December 31, 1977, had the effect of converting into no par value common shares of the capital stock of the Company $808 million of debt owed to the Government of Canada and consolidating all the elements of Shareholder's Equity other than retained earnings into such common shares. Concurrent with adoption of this legislation, the arrangement whereby the Government of Canada had made annual purchases of the Company's 4% preferred stock to provide for capital expenditure has been discontinued. The acquisition of 4% preferred stock by the Minister of Finance for 1977 was also restricted to an amount of $51,448,697, effectively reducing the amount of preferred stock as at December 31, 1977, by $22,542,145 to $1,555,926,732. Since the Act requires that the accounts of the System be amended as of December 31, 1977, to reflect the foregoing adjustments and the consolidation of the elements of Shareholder's Equity, the related comparative figures as at that date have been restated within the accompanying financial statements as set out below.

b. Retained Earnings

The legislation referred to in (a) above has also:

— provided for the retention by the Company of the net income for 1977 of $28.018 million;

— repealed the requirement that all earnings be paid to the Government unless the Government directed that all or part of such earnings be applied in discharge of specified Company obligations;

— required payment to the Receiver General for Canada of a dividend equal to 20% of net income for 1978 and subsequent years, or such greater percentage as the Governor in Council may direct; and

— repealed the statutory prohibition against funding any income deficit.

Consistent with the new legislation, a dividend in the amount of $27.2 million, representing 20% of the net income for the year 1978, has been accrued and is included in Other current liabilities.

	As Reported December 31, 1977	Adjustments Required	Consolidation into Common Shares	As Restated
		(in thousands)		
Current Assets	**$ 713,443**	**$ (22,542)**		**$ 690,901**
Long-Term Debt	**$2,376,253**	**$ (808,000)**		**$1,568,253**
Shareholder's Equity				
4% preferred stock of Canadian National Railway Company	$1,578,469	$ (22,542)	$ (1,555,927)	$ —
Capital investment of Government of Canada in Canadian Government Railways*	428,397	—	(428,397)	—
Reduction in recognition of depreciation attributable to years prior to the adoption of depreciation accounting	(807,813)	—	807,813	—
Capital stock of Canadian National Railway Company, no par value; 6,000,000 shares authorized, issued and outstanding	359,963	808,000	1,176,511	2,344,474
Retained earnings	39,782	—	—	39,782
	$1,598,798	**$ 785,458**	**$ —**	**$2,384,256**
Working Capital	**$ 123,981**	**$ (22,542)**	**$ —**	**$ 101,439**

**Capital investment of Government of Canada in Canadian Government Railways represented the assets entrusted to the Company by the Government of Canada for management and operation at the book values at the time of their entrustment.*

NOTE 6: Major Commitments

a. Lease Commitments

The Company's lease commitments as at December 31, 1978, of which the significant portion is in respect of railway rolling stock, are as follows:

	Non-Cancellable Leases	
	Capital Leases	Other
	(in thousands)	
Year ending December 31:		
1979	$ 31,105	$ 59,256
1980	34,605	56,278
1981	35,078	53,315
1982	35,221	50,323
1983	35,147	47,532
1984 - 1988	171,081	177,309
1989 - 1993	47,818	53,945
1994 - 1998	5,531	9,238
1999	805	623
Total minimum lease payments	396,391	$507,819
Less amount representing imputed interest	220,275	
Present value of net minimum lease payments under capital leases	$176,116	

Many of the leases provide renewal options and an option to purchase the property at fair market value at the end of the lease term.

Rental expenses under lease arrangements were:

	Year ended December 31	
	1978	**1977**
	(in thousands)	
Total expenses	$127,541	$115,287
Expenses under capital leases	$ 27,839	$ 26,214

Net reduction in income and increases in assets and liabilities in the consolidated financial statements, which would have arisen if leases satisfying the criteria of capital leases under accounting principles recommended by the Canadian Institute of Chartered Accountants effective January 1, 1979, had been capitalized, are as follows:

	Year ended December 31	
	1978	**1977**
	(in thousands)	
Net reduction in income	$ 5,475	$ 6,361
Increase in Assets		
Property Investment		
Leased property under capital leases	$210,009	$209,201
Less accumulated amortization	63,483	50,027
	$146,526	$159,174
Increases in Liabilities		
Current Liabilities		
Present value of obligations under capital leases	$ 10,806	$ 9,882
Non-Current Liabilities		
Present value of obligations under capital leases	$167,887	$176,971
Less current portion	10,806	9,882
	$157,081	$167,089

b. Other

The Company has entered into a commitment with a major Canadian steel producer to purchase over a six-year period starting August 1, 1978, $226 million worth of new rail.

NOTE 7: Subsidies

Revenues include the following subsidies:

	Year ended December 31 1978	1977
	(in thousands)	
Government of Canada		
a. payments under the Railway Act paid under authority of that Act and the related Appropriation Act in respect of certain uneconomic operations, services and prescribed rates which railways are required by the Railway Act to maintain	$238,045	$240,621
b. vessel subsidies	95,258	94,614
c. Maritime Freight Rates Act and Atlantic Region Freight Assistance Act subsidies	16,981	14,862
	350,284	350,097
Province of Quebec Montreal suburban commuter service subsidy	2,400	—
	$352,684	**$350,097**

NOTE 8: Pensions

The Company has retirement benefit plans covering substantially all its employees under which they are entitled to benefits at retirement age, based on compensation and length of service. Pension costs are as follows:

Year ended December 31 1978	1977
(in thousands)	
$ 175,960	$ 148,304

Effective January 1, 1978, the amount of past service costs remaining to be charged to operations was increased by $171.8 million as a result of an actuarial valuation as at December 31, 1977. This increase is being charged to operations over periods up to fifteen years from January 1, 1978, in annual amounts determined as a fixed proportion of related payroll costs, including principal and interest. The average annual amount to be charged to operations is $22.4 million in the first five years and $16.1 million in the next ten years.

The total amount of past service costs remaining to be charged to operations at December 31, 1978, based on the latest actuarial valuation as at December 31, 1977, (December 31, 1975 for the 1977 figures) adjusted for subsequent changes, amounted to:

	At December 31	
	1978	**1977**
	(in thousands)	
Canadian plans	$1,198,979	$1,048,841
U.S. plans	14,134	14,241
	$1,213,113	**$1,063,082**

This amount is being charged to operations in annual amounts, including principal and interest, as follows:

	Annual Cost (in thousands)
1979 - 1982	$ 128,810*
1983 - 1992	122,510*
1993 - 1996	27,046
1997 - 2014	22,936
2015 - 2027	22,040

**includes average annual amounts where payments are based on a proportion of payroll costs.*

The charge to operations in 1978 exceeded the funding requirement by $18.8 million. The cumulative excess of charges to operations over funding requirements, amounting to $42.0 million, is included in Other Liabilities and Deferred Credits. The actuarially-computed value of vested benefits at December 31, 1977, the date of the latest actuarial valuation, exceeded the total of the pension funds at that date by $613.3 million.

NOTE 9: Income Taxes

Undepreciated capital cost for income tax purposes exceeds the net book value of depreciable assets by about $1.2 billion which is available to reduce taxable income of future years. During the year assessments were received from Revenue Canada increasing income for tax purposes in respect of the years 1969 to 1976. Notices of objection have been filed objecting to the inclusion in income of $172 million and, in the opinion of Counsel, are likely to be successful. Accordingly, this amount has not been deducted from the aforementioned undepreciated capital cost.

The Company's effective tax rate in 1978 was 7.7% lower than the normal 48% due principally to inclusion in income of gains on sale of property of which only a portion is taxable.

NOTE 10: Anti-Inflation Act

The Anti-Inflation Act provided for the restraint of profit margins, prices, dividends and compensation during the period ended December 31, 1978. The System was subject to this legislation and has complied with it.

NOTE 11: Restatement of Comparative Figures

During 1978, changes were made to improve the classification of certain items and for comparative purposes the related figures for 1977 have been restated.

NOTE 12: Other Matters

a.
On March 31, 1978, a conditional sales agreement was signed with VIA Rail Canada Inc. whereby the Company sold at book value to VIA Rail Canada Inc. passenger-related equipment for $52,022,642. This amount is payable in 72 consecutive equal monthly payments of $722,537, terminating on April 1, 1984.

b.
During the year the Company sold land at market value to the Canadian Broadcasting Corporation for $19.5 million, which amount was applied in reduction of debt to the Government of Canada.

c.
Negotiations are continuing with the Government of Canada for the transfer from the Government to the Company of the vessels and facilities used in Atlantic Provinces ferry and coastal services which are at present operated by the Company together with certain funds for related capital expenditure purposes. It is expected that the Company will convey these properties and funds to CN Marine Inc. (previously known as CN Marine Corporation) which will thereafter provide the vessel services under compensatory contract arrangements with the Government. The value of assets transferred from Government ownership will be recorded as an increase in the Company's Shareholder's Equity.

COOPERS & LYBRAND
CHARTERED ACCOUNTANTS

To The Honourable The Minister of Transport,
Ottawa, Canada.

We have examined the consolidated balance sheet of the Canadian National Railway System as at December 31, 1978 and the consolidated statements of income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion these consolidated financial statements are properly drawn up so as to give a true and fair view of the state of affairs of the System as at December 31, 1978 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Also, in our opinion, proper books of account have been kept and the transactions that have come to our notice have been within the powers of the System.

Coopers & Lybrand

Montreal, Canada,
February 22, 1979

Chartered Accountants.

Companies included in the Consolidated Financial Statements of the Canadian National Railway System as at 31 December, 1978

Consolidated Companies

Autoport Limited
Canac Consultants Limited
Canac Distribution Ltd.
The Canada and Gulf Terminal Railway Company
Canadian National Express Company
Canadian National Hotels (Moncton) Ltd.
Canadian National Railway Company
The Canadian National Railways Securities Trust
Canadian National Realties, Limited
Canadian National Steamship Company, Limited
Canadian National Telegraph Company
Canadian National Transfer Company
Canadian National Transportation, Limited
The Canadian Northern Quebec Railway Company
Canalog Logistics Limited
Canat Limited
Canaven Limited
Central Vermont Railway, Inc.
Chalut Transport (1974) Inc.
Chapman Transport Limited
C.N. (France) S.A.
*CN Marine Inc.
CN Tower Limited
CN Tower Restaurants Ltd.
*Coastal Transport Limited
Cronin Transport Limited
Domestic Two Leasing Corporation
Domestic Three Leasing Corporation
Domestic Four Leasing Corporation
Duluth, Rainy Lake & Winnipeg Railway Company
Duluth, Winnipeg and Pacific Railroad Company
Duluth, Winnipeg and Pacific Railway Company
Eastern Transport Limited
Empire Freightways Limited
Grand Trunk Corporation
Grand Trunk Land Development Corporation
Grand Trunk-Milwaukee Car Ferry Company
Grand Trunk Radio Communications, Inc.
Grand Trunk Western Railroad Company
The Great North Western Telegraph Company of Canada
Hoar Transport Company Limited
Husband International Transport (Ontario) Limited
Husband Transport Limited
Husband Transport (Quebec) Limited
Midland Superior Express Limited
The Minnesota and Manitoba Railroad Company
The Minnesota and Ontario Bridge Company
Mount Royal Tunnel and Terminal Company, Limited
The Northern Consolidated Holding Company Limited
Provincial Tankers Limited
The Quebec and Lake St. John Railway Company
Royal Transportation Limited
Swan River-The Pas Transfer Ltd.
The Toronto-Peterborough Transport Company Limited

Jointly - operated and Other Companies in which the System has Investments

The Belt Railway Company of Chicago
Chicago & Western Indiana Railroad Company
Compagnie de Gestion de Matane Inc.
Computer Sciences Canada, Ltd.
The Detroit & Toledo Shore Line Railroad Company
Detroit Terminal Railroad Company
East Yard Development Ltd.
Eurocanadian Shipholdings Limited
*Halifax Industries (Holdings) Limited
Halterm Limited
Intercast SA
Metro Centre Developments Limited
Northern Alberta Railways Company
The Public Markets, Limited
The Shawinigan Falls Terminal Railway Company
Société du port ferroviaire de Baie Comeau-Hauterive
Telesat Canada
The Toronto Terminals Railway Company

*Acquired in 1978

In addition, the property of the Canadian Government Railways is entrusted to the Canadian National Railway Company as part of the System.

Pension Trust Funds Consolidated Statement

Pension Trust Funds — 1959 and 1935 Pension Plans — Consolidated Statement of Financial Position as at December 31

			1978	1977
			(in thousands)	
Investments	Bonds — quoted market value 1978 — $585,506; 1977 — $519,803		$ 648,370	$ 560,286
	Mortgages and loans — secured by real estate		363,461	329,570
	Real estate		63,312	63,274
	Equities			
	—stocks	$454,410		
	—convertible debentures	9,274		
	—funds temporarily invested pending purchase of stocks	159,115		
	Total — quoted market value 1978 — $691,518; 1977 — $570,417		622,799	602,043
	Short-term investments		88,355	35,801
			1,786,297	1,590,974
	Cash in banks		302	149
	Accounts receivable — Canadian National Railways		4,132	6,199
	Accrued interest and other assets		24,783	18,148
			1,815,514	1,615,470
Amount to be funded	Amount to be funded by the Company in accordance with the Pension Benefits Standards Act by periodic payments to December 31, 2006			
	Balance, beginning of year		1,072,018	1,058,720
	Add increases during year		187,299	14,429
	Deduct principal payments		(20,050)	(1,131)
	Balance, end of year		1,239,267	1,072,018
			$3,054,781	**$2,687,488**

See accompanying notes to Consolidated Statement of Financial Position

Auditors' Report

To the Honourable
The Minister of Transport
Ottawa, Canada.

We have examined the consolidated statement of financial position of the Pension Trust Funds — 1959 and 1935 Pension Plans of Canadian National Railways as at December 31, 1978. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances. The actuarial liability for pensions is the subject of a separate certificate of independent actuaries which accompanies the consolidated statement of financial position, the last actuarial valuation having been made as of December 31, 1977.

In our opinion, based on our examination and the actuarial certificate, this consolidated financial statement is properly drawn up so as to give a true and fair view of the state of affairs of the Pension Trust Funds as at December 31, 1978 and the results of their operations for the year then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Also, in our opinion, proper books of account have been kept and the transactions that have come under our notice have been within the powers of the Trustee.

Coopers & Lybrand

Chartered Accountants.
February 22, 1979.

Pension Trust Funds — 1959 and 1935 Pension Plans — Consolidated Statement of Financial Position as at December 31

			1978	1977
			(in thousands)	
Actuarial Liability for Pensions	**Balance, Beginning of Year**		$2,687,488	$2,520,594
	Additions During Year			
	Increases in liability for pensions resulting from			
	—Actuarial valuation as at December 31, 1977		171,807	—
	—Increases in pensions of existing pensioners		15,492	14,429
			187,299	14,429
	Contributions by employees on account of			
	—Current service		58,409	56,865
	—Prior years' service		5,665	6,103
			64,074	62,968
	Contributions by the Company including principal payments	$155,687		
	Principal payments applied to unfunded liability	20,050	135,637	122,455
	Net earnings on investments		128,114	99,146
			327,825	284,569
			3,202,612	2,819,592
	Deductions During Year			
	Pensions paid		140,377	124,993
	Refunds on termination of service		7,454	7,111
			147,831	132,104
	Balance, End of Year		**$3,054,781**	**$2,687,488**

On behalf of the board:
J. A. Dextraze, *Director*
R. A. Bandeen, *Director*

Actuarial Certificate

To the Trustee,
Canadian National Railways
Pension Funds.

This is to certify that the liability for pensions shown in the consolidated statement of financial position of the Pension Trust Funds — 1959 and 1935 Pension Plans of Canadian National Railways as at December 31, 1978, amounting to $3,054,781,000, in my opinion, represents adequate provision for the accumulated liabilities for pensions then approved and in force, pensions awaiting approval and pensions accrued to the above date in respect of employees then in service under the 1959 and 1935 Pension Plans.

Fellow of the Canadian Institute of Actuaries.

William M. Mercer Limited
Montreal, February 19, 1979.

Notes to Pension Trust Funds Consolidated Statement of Financial Position

1. Summary of Significant Accounting Policies

Plans included in Statement
The Pension Trust Funds Consolidated Statement of Financial Position includes the actuarial liability for pensions with respect to the 1959 and 1935 Pension Plans of Canadian National Railways and the related investments and unfunded liability.

Consolidation of Subsidiary Companies
The Pension Trust Funds have invested in a number of its wholly-owned subsidiary companies. The accounts of those companies are consolidated with the accounts of the Pension Trust Funds.

Investment Valuation
a. Bonds are carried at their amortized cost, plus deferred amounts arising from exchanges made to improve yields which are written-off over the remaining life of the bonds sold;

b. Mortgages and loans are carried at outstanding principal balances;

c. Real estate consists of land and buildings. Land is carried at cost less encumbrances and buildings at cost less encumbrances and accumulated depreciation;

d. Equities and short-term investments are carried at cost.

The quoted market value of investments in bonds and equities is based on the closing market quotations as of December 31.

Determination of Funding Payment
The actuarial cost method used is the accrued benefit — unit credit cost method.

The principal assumptions underlying the actuarial computations adopted by the Plans' actuary have been developed from the actual experience of the Plans in regard to the members' mortality, disability, retirement, termination of employment, and merit and periodic increases in earnings.

The funding payments, including liquidation of the unfunded liability, meet the requirements of the Pension Benefits Standards Act and regulations thereunder. Consistent with the regulations, the Company is funding its unfunded liabilities by annual payments over the following periods, calculated as shown:

— Unfunded liabilities as at December 31, 1976 — 30 years, as a percentage of payroll;

— Unfunded liabilities arising since December 31, 1976 —

Experience deficiencies — 5 years, as a percentage of payroll;

Changes in actuarial assumption — 15 years, as a percentage of payroll;

Increases in pensions of existing pensioners — 15 years, with the annual payments not being less than the total amount of the increased benefits paid in the year.

Accounting for Contributions
Contributions from employees are recorded in the period that the Company makes payroll deductions.

The recording of contributions by the Company is based upon amounts required to be funded with respect to accrued liabilities and the Company's current service liability.

Income Determination
Dividend income is recorded as of the ex-dividend date. Income from other investments is recorded as earned on an accrual basis.

Gain or loss on sales of equities is based on the average cost.

Foreign Exchange
Investments in United States funds are translated into Canadian funds at the historical rate prevailing when such investments were made, which, on average, approximates par. The quoted market values of these investments are translated into Canadian funds at the rate prevailing at year-end. Realized exchange gains or losses are reflected in net earnings for the year.

2. Commitments

Outstanding commitments to purchase mortgages and real estate investments amounted to $50,801,828 at December 31, 1978.

3. Subsequent Event

As a result of a series of transactions which became effective January 3, 1979, Canpar Oil and Gas Ltd., a subsidiary company, acquired an undivided 24% interest in the assets of Siebens Oil and Gas Ltd. for $53.5 million. The other 76% interest in the assets is owned by Dome Petroleum Ltd. which will manage all the assets.

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